

Protection against Professional Negligence

- IT/ITES Companies

P. Umesh observes that insurers should exercise sufficient caution while underwriting contracts that provide cover for professional indemnity as there can be unforeseen liability of a high order.

The judgment in the now famous BSkyB vs EDS case in UK has sent shock waves across the IT industry all over the world leaving a huge impact on the IT contracts - the way they are won, drafted and executed.

About BSkyB vs EDS: The lawsuit alleged that EDS, now owned by HP, had fraudulently misrepresented itself in a sales pitch in 2000 to design, build, manage, implement and integrate the process and technology for the CRM System, leaving BSkyB to pick up the pieces and take on heavy costs as it implemented the system itself. EDS, on the other hand, said BSkyB did not know what it wanted, and kept introducing new requirements, making it difficult to deliver. BSkyB made various claims including:

- Fraudulent misrepresentations by EDS in the tender process
- Negligent misrepresentations in relation to progress made to date, resources, planning and cost, which had led to BSkyB entering into the Letter Agreement; and
- a number of breaches by EDS of its obligations under the Contract which BSkyB alleged amounted to repudiatory breach.

The matter has come to a close with HP agreeing to pay BSkyB a total of £318 million in full and final settlement. The case is the most expensive legal dispute in the history of the IT industry in UK, costing both sides an estimated

£40m each in defence costs. The time taken for legal action to be concluded is six years and the days spent in court are 109 days.

Why should this bother the Indian IT industry?

The Indian IT industry draws sustenance mostly from the western world. It is now slowly recovering from the downturn caused by meltdown in major economies. The pressure on performance is increasing by the day. While it is important to win the contracts, it is becoming much more important to deliver the performance to the satisfaction of the customers for continued sustenance and growth.

Customer loyalty cannot be taken for granted in today's world because of inflation of expectations. Customers are now not necessarily sold to the idea of long term relationships. They demand result for every dollar they pay. They are not taking any failure or under performance on the part of the service providers in their stride. They expect the service providers to pay – for negligence or failure. This is likely to impact the balance sheet of the service provider, in case proper risk management practices including appropriate risk transfer mechanism are not put in place.

What can go wrong?

"Anything that can go wrong will go wrong". This Murphy's Law holds good here also.



Customer loyalty cannot be taken for granted in today's world because of inflation of expectations. Customers are now not necessarily sold to the idea of long term relationships.





Certain other important areas which are often overlooked are non-review of contracts in context of changing environments, changing customer expectations and evolving new needs (Merger & Acquisitions).



Let us begin with Contracting Practices: In the anxiety to win deals sometimes service providers cut short the required processes and practices. At times when they apprehend that certain issues are likely to become showstoppers, they may concede a lot of space to the customers in various areas. These may include undue flexibilities like leaving liability for compensation uncapped, accepting indirect and consequential losses and damages, leaving matters open ended in issues like whether a certain proposition is a part of maintenance or enhancement etc. Certain other important areas which are often overlooked are non-review of contracts in context of changing environments, changing customer expectations and evolving new needs (Merger & Acquisitions). Enough care is not taken while agreeing to the wordings of indemnity/ insurance clauses in the contract. Robust contract language is very imperative for avoiding unpleasant surprises.

The other important aspect from risk management perspective is Project Management: It is essential to have proper project management which includes well defined processes for every aspect of the project execution including well defined customer acceptance procedures and proper recording of all discussions and particularly change requests. Improper understanding of a (alien) language may result in translation errors which by itself can create fault lines in project management. Translation issues also contributed to claims in some cases. Catching up on warning signals early is also very important. To maintain quality deliverables, there should be no improper hastening up of any work. Fredrick Brooks summarized this law in The Mythical Man Month [2] when he stated, "The bearing of a child takes nine months, no matter how many women are assigned." Attempts to circumvent a project's natural minimum limits will backfire.

There could be a host of reasons which can result in claims against IT/ ITES companies.

Some of them are:

- Failure to complete and deliver crucial components.
- Failure to test and implement the applications and systems as promised.
- No tool in place to run regression and performance tests and very insufficient unitary tests and inexistent integration tests.
- No procedure for life cycle management
- Software fails, client can't offer services online as anticipated
- A routine test on a client's system causes a crash resulting in lost business.
- Software corrupted, data destroyed resulting in lost business/increased cost.
- Software fails, resulting in lost time and production & lost revenue.
- Failure to back up customer's data or inadvertent erasure of client's hard drive

The scenario is undergoing significant changes in the Indian context also with more claims, attributable to professional negligence, getting reported against Indian technology companies in the recent past.

Without accounting for the major claims reported recently, the average value of the claim is stated to be in the region of US\$ 4.5 million without taking into account defence costs and there are already about 3 dozen claims reported and in various stages of negotiation/development against Indian IT/ ITES companies. It may sound unbelievable - in the last six months, three large claims are reported, the largest one in the region of USD 100 million. In view of these developments, it is becoming increasingly necessary for Indian IT/ ITES organisations to take recourse to appropriate risk transfer mechanism and obtain right insurance protection going beyond basic contractual obligation of evidencing procurement of such policies. This

is where Errors & Omissions liability (E&O) insurance aka Professional Indemnity (PI) insurance assumes relevance.

E&O policy will pay for amounts that the insured is legally required to pay to compensate others (its customers) for loss resulting from the insured's wrongful act or that of another for whom the insured is legally liable. The policy covers damages as also defence costs. The wrongful act must be in the insured's performance of professional services for others for a fee. Wrongful act includes any actual or alleged negligent act, error or omission in the performance of professional services for others for a fee or in the failure of software products to perform the intended function or serve the purpose intended.

This policy which covers negligent acts can be extended to cover employee dishonest acts and also infringement of IPR. Some important exclusions in the policy are:

- Prior and pending acts
- Bad debts
- Warranties/Performance guarantees
- Delay in delivery unless caused by professional negligence.
- Infringement of patents and trade secrets.

This policy is offered as claims made policy – the policy covers claims made only while the policy is in effect. The effect is that coverage must be continued indefinitely to assure coverage for claims filed in the future for actions that occurred in the past. In this context, protection of the retroactive date for continuity of cover as in any other liability insurance assumes utmost significance. Jurisdiction is another important aspect of

liability insurance. It is necessary to choose the widest jurisdiction. It is possible to cover employees of the sub contractors also with specific approval of insurers. Insurers are open these days for negotiated settlements as against long drawn court battles. The quality of the insurance cover is very important and the insurance buyers should not fall into the trap of treating this kind of specialized business critical insurance cover as a commodity insurance purchase.

The consequences of professional negligence are too serious. They are not soft for the software industry. Requisite care while finalizing the contractual terms and conditions, proper project management practices supported by suitable risk transfer methods are necessary to mitigate the adverse impact from liabilities resulting from professional negligence towards protection of the balance sheet.

In today's increased litigation environment, for an IT/ ITES company a good E&O policy is not a "NICETO HAVE"; but, a "MUST HAVE".

The author is Senior Vice President - South, Raheja QBE General Insurance Company Limited, Hyderabad. The views expressed in the article are personal.

”

The quality of the insurance cover is very important and the insurance buyers should not fall into the trap of treating this kind of specialized business critical insurance cover as a commodity insurance purchase.

”